
Report of the Independent Auditors



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

November 15, 2010

The Honorable Arne Duncan
Secretary of Education
Washington, D.C. 20202

Dear Secretary Duncan:

The enclosed reports present the results of the annual audits of the U.S. Department of Education's financial statements for fiscal years 2010 and 2009, to comply with the Government Management Reform Act of 1994 (GMRA). The reports should be read in conjunction with the Department's financial statements and notes to fully understand the context of the information contained therein.

We contracted with the independent certified public accounting firm of Ernst & Young, LLP (Ernst & Young) to audit the financial statements of the Department as of September 30, 2010 and 2009, and for the years then ended. The contract required that the audits be performed in accordance with U.S. generally accepted government auditing standards and OMB's bulletin, *Audit Requirements for Federal Financial Statements*.

In connection with the contract, we monitored the performance of the audits, reviewed Ernst & Young's reports and related documentation, and inquired of its representatives. Our review was not intended to enable us to express, and we do not express, an opinion on the Department's financial statements, or conclusions about the effectiveness of internal control, whether the Department's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996, or on compliance with laws and regulations.

Ernst & Young is responsible for the attached auditor's report and the conclusions expressed in the related reports on internal control and compliance with laws and regulations. Our review disclosed no instances where Ernst & Young did not comply, in all material respects, with U.S. generally accepted government auditing standards.

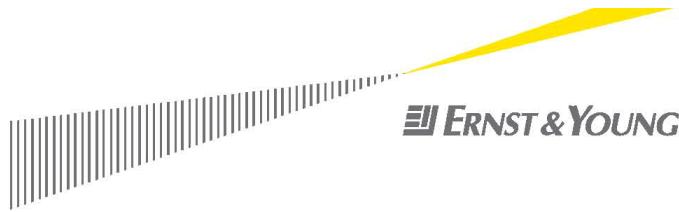
Sincerely,

A handwritten signature in blue ink that reads "Kathleen S. Tighe".

Kathleen S. Tighe
Inspector General

Enclosures

The Department of Education's mission is to promote student achievement and preparation for global competitiveness by fostering educational excellence and ensuring equal access.



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Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2010 and 2009, and the related consolidated statements of net cost, and changes in net position, and the combined statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Department's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2010 and 2009, and its net cost, changes in net position, and budgetary resources, for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 15, 2010, on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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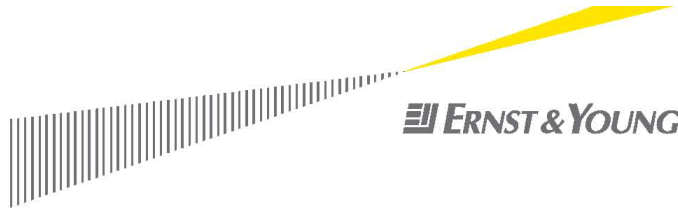
Report of Independent Auditors
Page 2

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management's Discussion and Analysis, required supplementary stewardship information, required supplementary information, and other accompanying information is not a required part of the basic financial statements but is supplementary information required by OMB Circular No. A-136, *Financial Reporting Requirements*. The other accompanying information has not been subjected to the auditing procedures applied in our audits of the basic financial statements and, accordingly, we express no opinion on it. For the remaining information, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

November 15, 2010

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Report on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

To the Inspector General
U.S. Department of Education

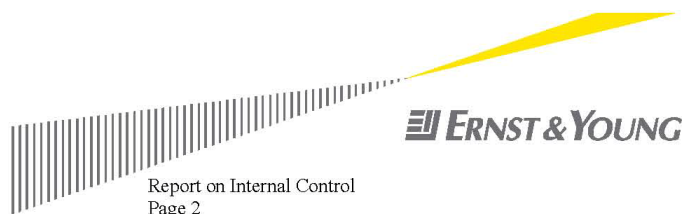
We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2010, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 15, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04, as amended. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the second preceding paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies in internal control over financial reporting. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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Report on Internal Control
Page 2

SIGNIFICANT DEFICIENCIES

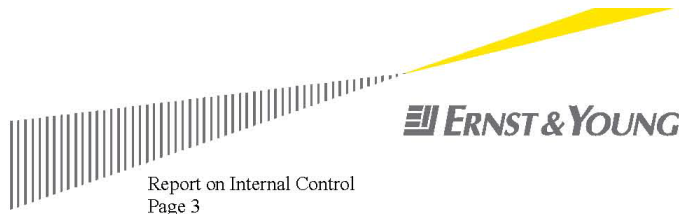
1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition) –

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such net costs are also re-estimated on a periodic basis. While improvements have been made over the last several years, we noted that internal controls and processes surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be maintained and further refined to ensure that appropriate estimates are prepared.

During the last few years, several pieces of legislation have been enacted that have had a significant impact on the Department's loan programs. The *Ensuring Continued Access to Student Loans Act of 2008* (ECASLA) legislation, which was enacted during FY 2008, amended the Federal Family Education Loan (FFEL) program and provided the Secretary of Education with the authority to purchase student loans from private lenders and enter into forward commitments to purchase FFEL loans. In October 2008, the enactment of Public Law (P.L.) 110-350 extended this temporary loan purchase authority through September 30, 2010. Additionally, the *Student Aid and Financial Responsibility Act* (SAFRA) included in the *Health Care and Education Reconciliation Act of 2010* (HCERA) was enacted during FY 2010. Under SAFRA, no new FFEL loans were authorized after June 30, 2010. This increased the Department's responsibility for originating federal student loans, primarily through the William D. Ford Federal Direct Loan program (direct loan program). As a result of SAFRA, the Department was required to implement the necessary processes surrounding the transition to originating a much increased volume of direct loans within a short time frame. The Department brought together representatives from throughout the organization to develop, implement and administer the activities surrounding the transition to direct loans and the temporary loan purchase authority. Representatives included individuals from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service.

During FY 2010, we noted that the Department documented certain meetings in these areas as part of the Credit Reform Workgroup meetings. Management informed us that representatives maintained communication throughout the year on both the activities related to the transition to direct loans and the temporary loan purchase authority. These meetings occurred on both a formal and informal basis. Such discussions are an important part in developing the periodic re-

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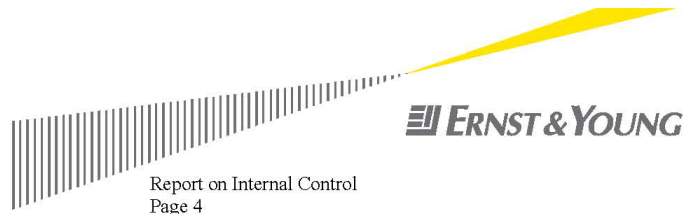


estimates for the direct and FFEL loan programs, since all the programs are interrelated. To the extent such groups execute critical review activities, they constitute a key control for the Department, and further structure and documentation around their activities can enhance confidence in the Department's estimation processes.

After identifying the challenges faced by the Department and the improvements in communication made or currently being made by the Department, we noted the following items that indicate management controls and analysis can be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the receivables related to the direct loan program and the temporary loan purchase authority, and in the liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability accounts. The model uses multiple sources of loan data and hundreds of complex assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM also produces a forecast of the expected cash flows in the current year for the outstanding loans which, when discounted, can be used to compare to the recorded activity in the general ledger. Comparisons using the backcast and forecast tools, and to the extent practical, recomputation of expected amounts based on loan volumes, interest rates, and simplified cash flow assumptions, can serve as key detect controls for potential undetected errors that may exist in the development of the assumption data and credit reform estimates. During our testing, we noted that management has no formal detailed review procedures surrounding the input of the many variables into the SLM, the input of cash flows into the OMB calculator or the process surrounding the analytical tools. Management does perform a high-level review of such data; however, this review is not sufficient to identify errors that may occur at a detailed level. In one instance during our testing, we noted an error in one of the allowance calculations that resulted in an adjustment to the financial statements of approximately \$900 million. Additionally, we noted calculation errors in certain of the analytical tools used by the Department, including the backcast, back of the envelope, and fluctuation analysis. While these calculation errors in certain analytical tools did not directly impact amounts in the financial statements, the analytical tools should contain accurate information if they are to serve their purpose as a detect control. Implementing a detail review process may reduce the potential for errors occurring in all aspects of this complex re-estimate and also in the analytical tools, leading to further refinement of the tools and facilitate their use in a formalized cross-functional review of the estimates.

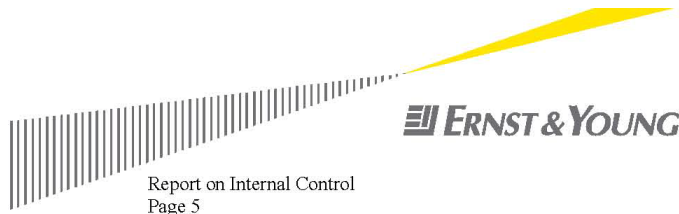
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Report on Internal Control
Page 4

- As noted above, the SLM produces a forecast of the expected cash flows in the current year for the outstanding loans which, when discounted, can be used to compare to the recorded activity in the general ledger. Additionally, other data analysis tools prepared by the Department, such as the cohort analysis, support more disaggregated reviews of data by cohort. The Department's financial systems are not configured to account for cash flows on a precise cohort level. Rigorous examinations and reconciliations using the cohort analysis data have not been fully successful in relating the net present value of estimated future cash flows embedded in the SLM to the corresponding amounts of: (1) adjusted debt balance and net receivables for the direct loan program, or (2) the adjusted Fund Balance with Treasury and liabilities for loan guarantees for FFEL guaranteed loans. Recent growth in the unexplained variances between these amounts highlights the need for management to devote substantial resources to comprehensively and definitively analyze the differences and work with OMB and Treasury to ensure complete transparency into this matter and the resolution thereof. Pending completion of this thorough cohort analysis, the advent of the temporary loan purchase authority programs and substantial increases in the volume of the direct loan program provide opportunities for the Department to implement rigorous cohort level accounting consistent with the requirements of the Credit Reform Act and applicable OMB guidance.
- The early phase of the loan estimation process includes the development of the assumptions, which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. During our review of the program logs for defaults, deferment, and forbearance, we encountered errors in certain of the computer programs for defaults, which appear to have stopped the program from processing certain steps. Additionally, based on a review of the log files for the deferment and forbearance assumptions, we noted that two of the models associated with the FFEL program did not converge. Lack of convergence may render estimation parameters unreliable, as the estimation process has not completed. After further inquiry, management informed us that the program errors and impact of the non-convergence were assessed and addressed as management deemed appropriate. However, management did not retain documentation surrounding their assessment of these issues. We noted enhancements in the detailed documentation for the deferment and default assumptions; however, the documentation could be further strengthened by adding additional detail, such as an assessment of the impact of the log errors and non-convergence issues, or reasons for adding to or removing variables from the models. We also noted that in some instances documentation of the steps performed by the Department did not precisely correspond with the computer programs themselves.

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- Consistent with credit reform implementation guidance, the Department relies significantly on prior patterns to estimate future cash flow activity. However, the Department should be more proactive in identifying conditions in which a refinement of such estimates should be made when circumstances suggest that fundamental patterns will change. For example, to the extent that lender or borrower behavior appears likely to have changed, or be changing, deviations from the use of historical data, or consideration of additional information to capture the impact of such changes, may be warranted in developing credit reform estimates. The current economic conditions, including high unemployment, reductions in credit availability for borrowers, and declines in home prices may have a significant impact on student loan borrowers and consequently on the Department's credit reform results. Many of these impacts have not been explicitly reflected in the Department's estimates.

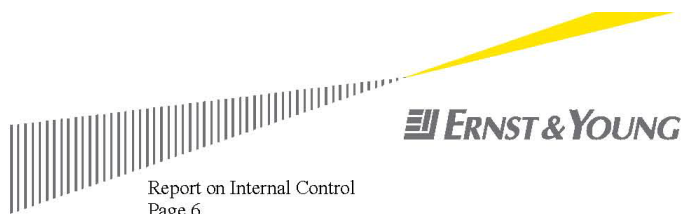
Since the Department's approach to estimating deferment, forbearance, and default rates includes unemployment rates for selected loan products, and since forecasts of these external factors are used in arriving at the projected deferment, forbearance, and default amounts, the Department's estimates would be expected to capture some of the indirect impact of the economic environment. However, since the models produce estimates using data that largely do not reflect recessionary conditions and for a significant period reflect what in hindsight has been assessed to be a credit bubble, the Department could gain additional insights by performing stress-testing around its estimates and, as necessary, postulating borrower and lender behavior that may occur assuming the current economic conditions last for varying lengths of time.

Recommendations:

We recommend that the Department of Education perform the following:

1. Continue to improve the analytical tools used for the loan estimation process, working to develop formats and content that synthesize and capture loan level data available in the Department's systems. Specifically:
 - Critically assess deferment, forbearance and default rates by cohort in light of recent changes in the economic environment to determine the extent to which there may be differences in performance across cohorts.
 - Perform additional forms of stress-testing estimates with additional variables, such as alternative unemployment, interest rate, Gross Domestic Product growth, and inflation scenarios.
2. Implement formal detail review procedures over the input of variables into the SLM, input of cash flows into the OMB calculator and other calculations surrounding the process to avoid potential errors that may negatively affect the re-estimates. Also,

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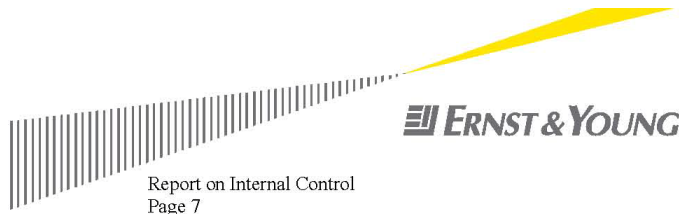
perform a detailed review of the input of source data included in the Department's analytical tools to avoid errors and ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.

3. Strengthen the documentation related to internally developed computer programs, including documentation of changes in the programs and variables used, review and resolution of errors appearing in logs, and adding detailed comments to the programs to enhance clarity of the code.
4. Dedicate appropriate time and resources to thoroughly analyze, evaluate, and resolve the unexplained variances between the net present value of the future cash flows and adjusted debt balance or Fund Balance with Treasury. Also continue efforts to more fully implement cohort reporting with specific research on whether balances in the Department's financial records are supported by estimates, by cohort, from the SLM and the cohort analysis tool and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts. Beginning initially with direct loans, utilize detail loan level data in NSLDS to develop summary cohort level data for each year of outstanding balances for comparison to projected future cash flows from liquidation of the loans as reflected in the SLM and cohort analysis tool.
5. Document in detail the consideration and ultimate resolution of scenarios under which early warnings from patterns in Department data and other indicators of stress on program participants would be expected to lead to model adjustments in anticipation of likely changes in cash flows and result in changes in credit reform estimates. Similarly, capture the value of financial-related data for the programs to provide information for decision-makers regarding possible prospective changes in the programs based upon indications of program participant performance, stress, and anticipated changes in behavior in response to changing market and economic conditions.

2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)

In connection with the annual audit of the Department's FY 2010 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

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Report on Internal Control
Page 7

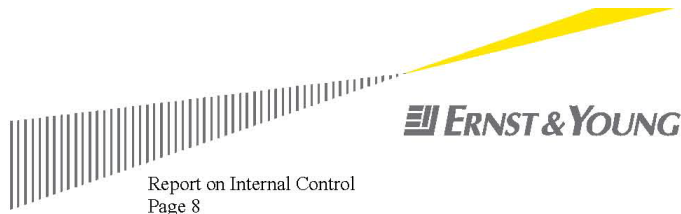
The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, the GAO publication states that:

- "management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management," and
- "internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved."

While the Department has worked toward strengthening and improving controls over information technology processes during FY 2010, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including repeat conditions, within information technology security and systems, that need to be addressed. During our review of IT general controls at the Department and FSA, we identified the following deficiencies: (1) lack of monitoring of the activities of administrator and privileged user accounts at the application layer; (2) access for terminated users was not removed in a timely manner or not removed at all; (3) revalidation of users' rights is not consistently performed for all applications and users, and for those revalidations that are performed, we noted instances in which there was no validation of the appropriateness of user access or users were not revalidated by the appropriate members of management; (4) password configurations for applications did not comply with the relevant Department or FSA policy; (5) documentation and related approvals required to provision user access are not consistently maintained; (6) administrator level access was assigned to individuals not requiring elevated privileges; (7) controls related to the change management process were not consistently applied during the audit period, specifically, documentation of approvals for application changes were not consistently maintained, improper segregation of environments exists where users have access to make changes to code and migrate changes to production, and select code elements are migrated to production without being tested; and (8) documentation related to interfaces, including but not limited to Interface Control Documents, Trading Partner Agreements, and Memorandums of Understanding, were not up to date.

The OIG has identified information technology related deficiencies for the Department and FSA in reports issued during fiscal year 2010. In its review of the Virtual Data Center, the OIG noted that FSA did not have adequate operational controls in place over configuration management, system and information integrity, contingency planning, media protection, and awareness and training. In addition, FSA needs to improve all four technical controls of access controls, systems and communications protection, identification and authentication, and audit and accountability. As it relates to OIG's Investigative Program Advisory Report, the OIG noted that the

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Department and FSA have not performed adequate log reviews as it relates to the identification of unauthorized activity for compromised accounts. In addition, FSA does not keep adequate records of its remediation efforts for compromised accounts. The OIG reviewed the implementation of the Managed Security Services Provider (MSSP) contract and noted that the Department has not implemented measures to effectively support the MSSP contract. Specifically, the current contractor is unable to provide the level of service required by the contract due to lack of required access. As a result, while the Department has procured services from the MSSP contractor, the Department has not ensured that its information technology network is adequately protected. Finally, during OIG's review of FSA's Financial Management System, the OIG found FSA did not have adequate controls in place over personnel security and security and awareness training.

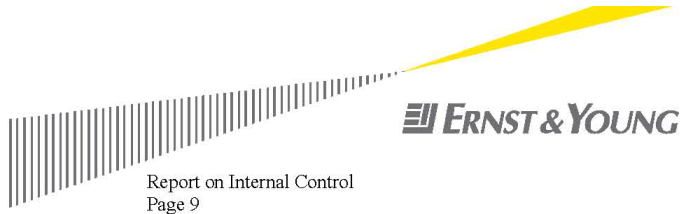
In addition, several of the above deficiencies are repeat conditions (although for different platforms or systems) that were noted in our work and in the OIG's audit reports, an indication that the control environment and monitoring components of internal controls at the Department require additional focus.

Recommendations:

Applications and related infrastructure are supported by a number of separate groups within the Department and FSA. While these groups have attempted to implement controls promulgated by Department, FSA, OMB, and National Institute of Standards and Technology guidelines, control processes and practices continue to be implemented in a disparate manner across these groups. In addition, audit resolution activities have traditionally been performed by each separate group and have largely focused around addressing the immediate security and control weaknesses identified by audit reports.

We recommend that the Department continue its efforts to address security and control weaknesses disclosed in audit reports or identified in internal self-assessments with an emphasis on addressing the root cause of the security or control weakness uniformly across the organization, which should decrease the likelihood of a similar weaknesses being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, allocating appropriate resources and subject matter resources to information technology process areas, maintaining updated procedures to ensure proper configuration of servers against documented standards at the time of changes in the environment, and monitoring of contract performance of vendors providing system support services to the Department. As appropriate, the specific security and government standards that are to be applied, and approaches to achieving and monitoring such compliance, continue to merit additional focus in contracts the Department executes with service providers.

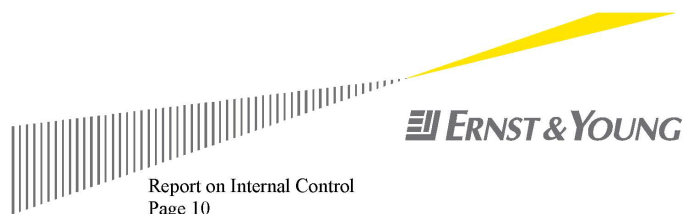
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Report on Internal Control
Page 9

More specifically the Department should: (1) implement standards around the logging of privileged user access and activities and establish controls over the monitoring of that access; (2) strengthen access controls to protect mission critical systems (e.g., periodic access revalidation, timely removal of user access, enforcement of changes in access due to changes in roles and responsibilities); (3) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with Department and FSA policy; (4) enhance its security training and awareness program, specifically around actions to be taken in the event an employee encounters suspicious activity; (5) revise current methods of identifying and logging suspicious activity as it relates to unauthorized access accounts and data; (6) document and update as required information pertaining to system interfaces including Interface Control Documents, Trading Partner Agreements, and Memorandums of Understanding; (7) implement two-factor authentication on any system where a user can log into a privileged account from the Internet; and (8) evaluate alternatives for obtaining MSSP services and proceed with a solution that will allow for adequate network protection.

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Report on Internal Control
Page 10

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the FY 2009 audit of the U.S. Department of Education's financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Summary of FY 2009 Significant Deficiencies

Issue Area	Summary Control Issue	FY 2010 Status
Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Significant Deficiency)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Modified Repeat Condition classified as a Significant Deficiency
Controls Surrounding Information Systems Need Enhancement (Significant Deficiency)	Improvements are needed in overall information technology security and systems.	Modified Repeat Condition classified as a Significant Deficiency
Additional Focus on Controls and Financial Reporting Processes Related to the American Recovery and Reinvestment Act is Needed	Management controls need to be strengthened over cash management activities and non-routine grant accrual procedures related to <i>American Recovery and Reinvestment Act of 2009</i> funding.	Improvements Noted – Not classified as a significant deficiency at September 30, 2010

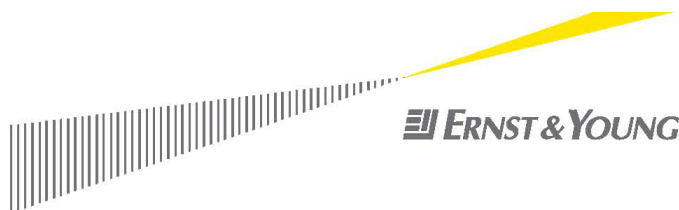
We have reviewed our findings and recommendations with Department management. Management generally concurs with our findings and recommendations in their response and will provide a corrective action plan to the OIG in accordance with applicable Department directives. We did not audit management's response, and accordingly, we express no opinion on it.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst & Young LLP

November 15, 2010

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**Report on Compliance and Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards***

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2010, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 15, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04, as amended, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04, as amended.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

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Report on Compliance and Other Matters
Page 2

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. We have identified the following instance of noncompliance:

While the Department has worked toward strengthening and improving controls over information technology processes during FY 2010, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including repeat conditions, within information technology security and systems, that need to be addressed. During our review of information technology general controls at the Department and FSA, we identified the following deficiencies: (1) lack of monitoring of the activities of administrator and privileged user accounts at the application layer; (2) access for terminated users was not removed in a timely manner or not removed at all; (3) revalidation of users' rights is not consistently performed for all applications and users and for those revalidations that are performed, we noted instances in which there was no validation of the appropriateness of user access or users were not revalidated by the appropriate members of management; (4) password configurations for applications did not comply with the relevant Department or FSA policy; (5) documentation and related approvals required to provision user access are not consistently maintained; (6) administrator level access was assigned to individuals not requiring elevated privileges; (7) controls related to the change management process were not consistently applied during the audit period, specifically, documentation of approvals for application changes were not consistently maintained, improper segregation of environments exists where users have access to make changes to code and migrate changes to production, and select code elements are migrated to production without being tested; and (8) documentation related to interfaces, including but not limited to Interface Control Documents, Trading Partner Agreements, and Memorandums of Understanding, were not up to date. The OIG has identified information technology related deficiencies for the Department and FSA in reports issued during fiscal year 2010. In its review of the Virtual Data Center, the OIG noted that FSA did not have adequate operational controls in place over configuration management, system and information integrity, contingency planning, media protection, and awareness and training. In addition, FSA needs to improve all four technical controls of access controls, systems and communications protection, identification and authentication, and audit and accountability. As it relates to OIG's Investigative Program Advisory Report, the OIG noted that the Department and FSA have not performed adequate log reviews as it relates to the identification of unauthorized activity for compromised accounts. In addition, FSA does not keep adequate records of its remediation efforts for compromised accounts. The OIG reviewed the implementation of the Managed Security Services Provider (MSSP) contract and noted that the Department has not implemented measures to effectively support the MSSP contract. Specifically, the current contractor is unable to provide the level of service required by the contract due to lack of required access. As a result, while the Department has procured services from the MSSP contractor, the Department has not ensured that its information technology network is adequately protected. Finally, during OIG's review of FSA's Financial Management System, the OIG found FSA did not have adequate controls in place over personnel security and security and awareness training.

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Report on Compliance and Other Matters
Page 3

Our Report on Internal Control dated November 15, 2010, includes additional information related to the financial management systems that were found not to comply with the requirements of FFMA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and, to the extent findings and recommendations were noted in prior years, has provided a proposed action plan to the OIG in accordance with applicable Department directives. We did not audit management's proposed action plan and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst & Young LLP

November 15, 2010

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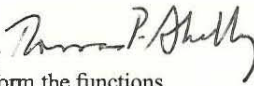
UNITED STATES DEPARTMENT OF EDUCATION


WASHINGTON, D.C. 20202-_____

NOV 10 2010

MEMORANDUM

TO: Kathleen S. Tighe
Inspector General

FROM: Thomas P. Skelly 
Delegated to perform the functions
and duties of Chief Financial Officer

Danny A. Harris, Ph.D. 
Chief Information Officer

SUBJECT: DRAFT AUDIT REPORTS
Fiscal Years 2010 and 2009 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17K0001

Please convey our sincere thanks and appreciation to everyone on your staff who worked diligently on this financial statement audit. The Department reviewed the draft Fiscal Years 2010 and 2009 Financial Statement Audit Reports. Without exception, we concur and agree with the Report of Independent Auditors and the Report on Internal Control. We also concur and agree with the Report on Compliance with Laws and Regulations.

We will share the final audit results with responsible senior officials, other interested program managers, and staff. At that time, we will also request the preparation of corrective action plans to be used in the resolution process.

Again, please convey our appreciation to everyone on your staff whose efforts permitted the Department to complete the audit within the established timeframe.

Please contact Gary Wood at (202) 245-8118 with questions or comments.

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